

# Office of Utility Regulation

## Guernsey Electricity Limited Price Review 2010

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### Draft Decision

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**Document No:** OUR 11/04

**February 2011**

**Office of Utility Regulation**  
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## 1. Introduction

The current price control<sup>1</sup> for Guernsey Electricity is due to expire on 31<sup>st</sup> March 2011 and a new control will therefore commence from 1<sup>st</sup> April 2011. This will be the fourth price control period for Guernsey Electricity Limited (GEL) since its commercialization in 2002. The OUR consultation paper (OUR10/13), which invited comment from stakeholders, set out the issues under consideration and the process which the DG will follow in arriving at a new price control for Guernsey Electricity.

This Draft Decision paper set out the key aspects of the price control for Guernsey Electricity. Following the consultation, there have been a number of changes to the DG's proposals as a result of comments received. The main points of the responses are summarised below, together with the OUR's interpretation of the responses on the key areas of consultation.

For this price review the DG has decided to issue a one year price control for 2011-12 rather than the originally proposed 4 year price control. He has also decided to move from a price limit control (determining maximum price increases applicable to all tariffs) to an overall revenue cap.

The overall price control for 2011-12 is RPI+2.8%.

This is close to the figure sought by GEL in its submissions, in which it sought a 7% increase in prices for 2011-12, equivalent to RPI + 3.5%.

However, there are a number of differences in the detail between GEL's request and the DG's decision. Most notably:

- The DG lifted the cap on tariffs by 8.5% in April 2010 to allow recovery of passthrough costs for the 2009/10 year based on provisional estimates of those costs. Final figures for that year now imply a further uplift in the cap on tariffs. GEL has claimed an additional £6.7m for 2009/10, requesting recovery of only £0.4m through price changes in April 2011 with the remainder recovered at a later unspecified date. The DG has made provision for a pass through of £1.6m as the final settlement for 2009-10.
- The DG has not included (and nor did GEL seek) any uplift in prices for 2011-12 to take account of the pass through of increased costs incurred in 2010-11. This will be addressed via the CPT (cost pass through) mechanism or at the next price review in 12 months, based on responses to this draft decision.
- GEL do not include an explicit efficiency reduction target in their own proposal. The DG has decided to set an efficiency target for GEL of 5.5% per annum of its non pass

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<sup>1</sup> OUR 07/04

through costs and to complete the remaining efficiency programme set out by PPA and agreed at the last price review. The DG has allowed for increases in operating costs where they are driven by external market prices (oil and electricity imports) and GEL will continue to be protected against these by the CPT (Cost Pass Through) mechanism.

*Disclaimer*

*This document does not constitute legal, commercial or technical advice. The Director General is not bound by it. The consultation is without prejudice to the legal position of the Director General or his rights and duties to regulate the market generally.*

## 2. Structure of this Draft Decision Paper

This Paper sets out the Director General (the DG) of Utility Regulation's Draft Decision on the Price Control for Guernsey Electricity for the period commencing 1 April 2011. The paper sets out a brief summary of the responses received from the consultation document OUR 10/13, the DG's approach to price setting for the period post 1 April 2011, and the Draft Decision itself.

### Structure

*The rest of this paper is structured as follows:*

- Section 3:** *summarises the legal framework of this price control;*
- Section 4:** *reviews the consultation issue by issue;*
- Section 5:** *summarises the price setting process;*
- Section 6:** *Describes the Cost Pass Through mechanism;*
- Section 7:** *Sets out the Draft Decision*

### Comments

Interested parties are invited to submit comments in writing on the matters set out in this consultation paper to the following address:

Office of Utility Regulation,  
Suites B1& B2  
Hirzel Court  
St Peter Port  
Guernsey  
GY1 2NH  
Email: [info@regutil.gg](mailto:info@regutil.gg)

All comments should be clearly marked "**Response to OUR Draft Decision on Guernsey Electricity Price Control**" and should arrive before **5pm on Friday 4 March 2011**.

*In line with the policy set out in Document OUR 05/28 – "Regulation in Guernsey; Revised Consultation Procedures", the DG intends to make any comments received available on the OUR website. Any material that is confidential should be put in a separate annex and clearly marked so that it can be kept confidential. However, the DG regrets that he is not in a position to respond individually to the responses to this consultation. Any comments received will be taken into account by the DG in informing a final decision for publication in March 2011.*

### 3. Legislative and Licensing Background

#### Overview

The legislative framework underpinning the regulatory regime for the electricity sector is governed by:

- The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 (the “Regulation Law”);
- The Electricity (Guernsey) Law, 2001 (the “Electricity Law”);
- The Electricity (Guernsey) Law 2001 (Commencement and Amendment) Ordinance 2001; and
- States Directions to the DG adopted by the States of Guernsey<sup>2</sup>.

The Electricity Law defines the three activities that constitute the electricity supply chain under the current legislative framework. These are:

- the generation of electricity;
- the conveyance of electricity across the electricity network; and
- the supply of electricity directly to homes and businesses.

These terms are defined in the Electricity Law and govern the current licensing framework which is outlined below.

#### Current Licensing Regime

The States of Guernsey has issued a number of States Directions in relation to the licensing of electricity activities in Guernsey. In accordance with those Directions the DG issued the first licences for electricity generation, conveyance and supply to the incumbent electricity company – GEL - on 1st February 2002.

The market for generating electricity is, in principle, open to competition. In terms of conveyance, under the current regime no other operator can lay electricity cables until 2012 and anyone generating electricity must therefore use the existing electricity network of GEL to convey that electricity from their generation plant to customers. Until 2012 only GEL may sell electricity to end customers.

#### Legislative Background to Price Regulation

Section 5(1) of the Electricity (Guernsey) Law, 2001, provides that the DG may include in licences such conditions as he considers necessary to carry out his functions. The Law specifically provides that such conditions can include (but are not limited to) conditions regulating the price premiums and discounts that may be charged or (as the case may be) allowed by a licensee which has a dominant position<sup>3</sup> in a relevant market<sup>4</sup>.

In accordance with these provisions, the “Electricity Licence Conditions” include the following condition 20.2:

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<sup>2</sup> *Billet d’Etat No.XVIII 2001, pages 1263-1264 and Billet d’Etat I of 2003, p.55*

<sup>3</sup> *Condition 5(1)(f) of the Electricity (Guernsey) Law, 2001.*

<sup>4</sup> *Section 22 of “The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 states that:*

*“A dominant position in relation to a relevant market shall be construed as it would be in the United Kingdom under the Competition Act 1998, but with the substitution, where appropriate, of references to the Bailiwick for references to the United Kingdom.”*

*The Competition Act 1998 utilises the definition of dominance that has developed under European Community Competition Law.*

“The DG may determine the maximum level of charges the Licensee may apply within a relevant market in which the Licensee has been found to be dominant. A determination may;

- (a) provide for the overall limit to apply to such charges;
- (b) restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; and
- (c) provide for different limits to apply in relation to different periods of time falling within the periods to which any determination applies.”

This condition allows the DG to regulate the prices that a licensee charges for its electricity services in a way and for a period that he deems appropriate, provided the licensee has a dominant position in the relevant market.

As set out in a previous OUR document (OUR03/07), Guernsey’s retail electricity market currently possesses a monopolist/dominant operator that also has a dominant position throughout the electricity supply chain. This position of economic strength is unlikely to change in the near to medium term. In this context, it is essential the social objective of maintaining the affordability of electricity provision, thus underpinning economic growth, is safeguarded. In the absence of competition, price control is widely accepted as the most appropriate tool to achieve this.

The OUR also wish to highlight the States guidance to T&R at the time of commercialisation of GEL. This guidance stated, inter alia, that:

*4. Financial performance targets for Guernsey Electricity Limited shall be set so as to:*

- 1. deliver improved efficiency in fulfilling the requirements of the Public Supply Obligation imposed under the regulatory regime whilst drawing a balance between seeking a commercial return on the resources employed and the effect on the community of any increase in charges which may result; and*
- 2. achieve as soon as is practicable an appropriate commercial return on the resources employed in the provision of other services.*



## 4. Summary of responses to the consultation

The OUR received five responses to its consultation document OUR 10/13:

- C&W Guernsey (SURE)
- Guernsey Gas Limited
- Culture & Leisure Department
- One private individual, Yvonne Burford
- Guernsey Electricity Limited

This section sets out the areas of consultation raised in OUR 10/13 and the specific questions on which the DG chose to consult. Each issue is discussed below, referring to respondents' comments where appropriate.

### Structure of Price Control

#### *Form*

*The DG consulted on whether an RPI-X form of price control remains an appropriate approach to the regulation of GEL's prices or whether an alternative is more appropriate.*

#### **Response**

There was support for this form of price control.

**The DG proposes to use the RPI-X approach to price setting.**

#### *Period*

*The DG proposed to set prices for a four year price control period from 1<sup>st</sup> April 2011. Respondents were invited to submit views on the appropriate period of the price control.*

#### **Response**

A number of respondents (including GEL) proposed shorter durations for the control, ranging from three years to a single year. GEL expresses a strong preference for a one year price control.

**The DG has decided to apply a single year price control for 2011-12 given the need to ensure the new CPT mechanism is appropriate in practice and the generally uncertain economic climate impacting on a number of significant variables relevant to this price control.**

#### *Scope*

*The DG wished to confirm that the tariffs listed were the relevant tariffs on which the proposed price control of GEL's core business should be based over the next control period. (See annex A For the listed tariffs).*

## **Response**

All of the responses to the consultation raised tariff related issues. Some expressed concern that information was not publicly available – for example, GEL does not publish its electricity buy back tariff. Other concerns were the level of charges for large users, the application of standby charges for customers who have invested in their own generation, differences in peak/off-peak charging periods for different customer groups, the need for discounts for large users and (in one instance) the need for for additional premiums for large users.

**The DG believes these responses raise sufficient concerns that this is an area which merits further investigation to determine whether tariffs are cost reflective, reasonable and in accordance with States policy.**

**The DG will separately set out the terms of reference for a review. GEL would make its own assessment of the various tariffs and report to OUR on its findings before the next price control is implemented, with adequate time allowed to consult interested parties ahead of the price review.**

**In the meantime, the DG requests that GEL publish:**

- **all tariffs used by customers including tariffs that are no longer available to new customers but continue to be used by existing customers (“legacy tariffs”);**
- **the criteria for customers to remain on legacy tariffs and set out their plans (if any) to migrate customers from discontinued tariffs;**
- **the criteria for the application of their charges for standby generation; and**
- **the buy back tariff for customers.**

## ***Monitoring and Compliance***

*The aim is to allow GEL to demonstrate that it has met its obligations, with the following objectives:*

- *to minimise the resources required for compliance and monitoring;*
- *to maximise transparency and certainty for GEL to make its pricing decisions;*
- *to ensure that tariffs do not exceed the levels set by the DG;*

*Respondents were asked to comment on this view, suggest alternatives and give reasons for these.*

## **Response**

There was support for OUR’s objective to minimise the regulatory burden. GEL believes that it would be more efficient for the business to set its own tariffs.

**The DG proposes to continue with these objectives as they stand. The DG notes that moving to a revenue cap will allow GEL more freedom to set its own tariffs but does not believe that the setting of the overall revenue limit should be carried out by GEL.**

## Financeability and Save to Spend

### *Financeability & save to spend reserve*

Respondents were asked to comment on the “save to spend” approach to funding GEL and whether the key financial measure should be the level of cash in this reserve and on three specific questions.

- *Is there a need for regulatory intervention given the issues set out above?*
- *Will this approach approximate the level of the Save to Spend Fund as if it had been separately maintained throughout the period? If not, is there an alternative?*
- *Should interest earned since commercialisation be added to the Save to Spend Fund?*

### **Response**

One respondent commented that being forced to borrow funds rather than rely on a cash reserve would focus attention on reducing costs and improving financial performance of the business. Although there was some comment that “save to spend” was not the ideal way to finance GEL investment, it was recognised that this was the reality of the States policy and therefore it should be effectively managed and ring fenced. Stakeholders should agree what can be funded and OUR and GEL control spend accordingly. At least one respondent felt that assumptions about the reserve should reflect the actual position – including any “unauthorised” investments or use of the reserve to subsidise other activities.

**The DG proposes to continue his work to ring fence this reserve. The OUR will work with GEL to define a starting point and on the allocation of the reserve for the core business going forwards.**

**The financeability assessment for this review has used a pessimistic view of the current balance of the save to spend reserve as a starting point (in line with GEL’s own calculations) to ensure that even in a worst case scenario the investment programme can be delivered.**

**Future investments that are not an agreed part of the investment plan are normally assumed to be from other funds available to a business. They would not reduce the balance of the reserve nor be allowed in the regulatory asset base or future depreciation allowances.**

**With no objection from the general responses, the DG will in future assume that interest earned accrues to the save to spend reserve.**

## **Rate of Return**

*Respondents were invited to submit views on the appropriate cost of capital that should be applied to GEL's post commercialisation assets. It was noted that the return on pre-commercialisation assets was not an issue for consultation as it was resolved by the Independent Expert Panel (IEP) in 2006.*

### **Response**

GEL emphasised the need for stability in this area, the business' fundamental financials have been agreed and all parties would benefit from a period of stability in this regard. GGL stated their view that the Rate of Return (RoR) on GEL's pre-commercialisation assets should be revisited. They proposed a figure of 4.3% for these assets and that the RoR for post-commercialisation assets should be based on the WACC (weighted average cost of capital) used by Ofgem in the UK for the last gas and electricity distribution review plus a 1% premium. This would give a WACC of 5% (post tax).

**The DG proposes to use the existing Rate of Return for post-commercialisation assets. In the consultation it was noted that the issue of the RoR for GEL's pre-commercialization assets had been addressed by the Independent Expert Panel, which set a specific approach for the treatment of the return on these assets. The DG noted that this was an issue that had been resolved and was not an issue for consultation at this price review. No new evidence has been provided which persuades him of the need to reopen this issue.**

## **Capital Expenditure & Incentives**

*The consultation document set out GEL's plans for capital investment in order to increase its generating capacity to meet future increases in peak demand and to maintain capacity in line with the "N-2" security of supply policy.*

*The DG also proposed the introduction of an incentive mechanism on GEL's investment and comments were sought on:*

- (1) the overall assessment of capex;*
- (2) the merit in incentivizing GEL to pursue alternative approaches to defer or reduce the need for significant generation plant investment.*
- (3) the appropriateness of using incentives on GEL's capital investment programme and the preferred form of those incentives.*

### **Response**

Responses on this issue were varied. GEL welcomed the OUR's change in emphasis from detailed investigation of its plans to a focus on demonstrating that programme is delivered effectively and efficiently to the benefit of customers. However, they did not support the introduction of new incentive mechanisms for capital expenditure, preferring to rely on their internal governance and the shareholder role to achieve the appropriate oversight and governance. Other respondents raised concerns that GEL's investment was being driven by

peak demand and questioned whether this was being driven by heating load or demand from data centres. It was noted that customers' own investment in backup generation helps to reduce peak demand. It was suggested that this along with better forecasting involving customers themselves and/or demand side management could contribute to reducing peak demands and hence the need for investment.

**The DG proposes to use the approach set out the consultation. There is strong reason for the DG to pursue alternative approaches to defer or reduce the need for significant plant investment to reduce the cost of the investment programme and its impact on customer's bills. For major investments such as new generation plant proposed by GEL, the company requires certainty over its investment programme and in particular, which items will be allowed.**

**The DG notes the concerns raised by the RPI report<sup>5</sup> about the shareholders role and its ability to monitor and oversee company investments. He also notes that the shareholder's interest and customer interests are not the same thing.**

**Therefore the DG agrees the company's capex programme as proposed, but requires them to provide and publish more information. This will set out a clear framework timetabling the investment and key milestones, and identifying when the benefits of the programme will be delivered to customers. This will be used as a benchmark against which the investment programme will be monitored.**

**The DG also intends to put in place an incentive scheme along the lines outlines in the consultation paper. While he recognises the issues of this approach for a single year price control, it is important that incentives are maintained and that the risks of investments are shared between the company and its shareholder and customers as a whole.**

## **Tariffs**

*Comments were sought on two specific tariff issues.*

*(i) whether GEL should be required to assess the extent to which different customers value different levels of security of supply. If so, how might the costs of security of supply be allocated between these different customers and over what timescale is such an adjustment reasonable?*

*(ii) whether volume based discounts are a material issue and if so how this might be addressed.*

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<sup>5</sup> RPI report: Review of Guernsey's Utility Regulatory Regime, a report for C&E Dept prepared by Professor George Yarrow and Dr Christopher Decker, 15 October 2010.

## Response

Tariff issues were a main focus of the responses to the consultation.

On the specific issues, first C&W responded, contrary to what might be expected for the provision of 24/7 data centres, they required a lower standard of security of supply than the “N-2” criteria used for Guernsey as a whole and they were concerned that they were cross-subsidising a higher standard of service for other customers.

On volume discounts, perhaps not surprisingly, the majority of large users responding to the consultation expressed some dissatisfaction with current tariffs. They felt that tariffs did not recognise the lower costs to GEL of large users for either the security of revenue they provide or their lower costs per connection. It was also noted that GEL may not be making the most of this resource by discouraging investment in on site and backup generation with its standby charges and lack of transparency in its buy back tariff. In contrast, the individual response received suggested that large users should pay a higher price for electricity to encourage reduced consumption and to fund renewable energy generation.

**The DG has taken note of the general concerns with tariffs. He requested GEL to publish more tariff information than at present, including prices for its buy back tariff (see above). However, rather than attempt to address all of the tariff issues raised in response to the consultation in a one year price review, he is inclined to set out the basis for a review of tariffs on a comprehensive basis by GEL and carry out a more thorough investigation later in the year to determine whether there is a need to review or rebalance some of the tariffs currently offered by GEL.**

**He has decided to move from exercising the price control in the form of limits to price increases for existing tariffs to an overall revenue cap for GEL. This will allow the company greater flexibility to review and amend its own tariffs in line with any need to rebalance or ensure cost reflectivity. This change is also recognised in the proposed changes to the Cost Pass Through mechanism set out in detail later in this paper.**

## CO2 Emissions

### *Favouring the cable link as a low carbon emission source*

*Evidence was sought from respondents on the level of carbon intensity of the interconnector and the principles which should be adopted to inform energy policy.*

## Response

This issue was raised to inform the Energy Policy Group’s consideration of this issue. As noted in the consultation document, this is clearly a high profile area of discussion, one which forms part of a much wider debate on climate change and CO2 emissions and an area of particular interest for electricity consumers. There were a number of strong opinions expressed on methods of calculation and the criteria that any approach should meet.

In terms of assessing the carbon intensity of various forms of electricity generation, the DG takes the view that this should be in line with generally accepted practice. Given that Guernsey's overall emissions of CO<sub>2</sub> are reported under the UK as signatory to the Kyoto protocol, the methodology should so far as possible mirror that used in the UK.

Of particular relevance is 'Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003', as regards the labelling of information on environmental impact. Article 3 (6) of that directive requires Member States to ensure that electricity suppliers specify, at a minimum, where information on the environmental impact can be found, on emissions of CO<sub>2</sub> and the radioactive waste resulting from the electricity produced by the overall fuel mix of the supplier over the preceding year.

**It is the DG's view therefore that both CO<sub>2</sub> and radioactive waste are relevant to any consideration of the environmental impact of using the interconnector and Guernsey Electricity should therefore be provided with this relevant information for its imported supplies by EDF energy. While it is easy to focus on CO<sub>2</sub> emissions, another element of fuel labelling is that EDF should also report the amount of nuclear waste created by Guernsey's use of imported nuclear power. It is not OUR's role to make a judgement about the relative merits of various forms of generation from the perspective of their environmental impact, but for policy makers it is important that the relevant information is disclosed, whether for imported, fossil fuel or renewable generation.**

## Operating costs

*Efficiency targets in generation costs in the current price control are based on the recommendations by PPA, a power consulting firm, who advised the DG following a review of GEL's generation business in 2006. The principal recommendations in that assessment would appear to remain relevant and the DG proposes to rely on this again to set operating cost based on the resourcing requirements considered efficient to support on-island generation as discussed in Section 7.3 of the OUR's consultation paper OUR 06/17.*

Respondents were requested to consider the merits of the approach to setting overhead and generation costs for the next price control, in particular evidence of developments that might alter the relative strength of the arguments for this approach.

### Response

Because much of the detail relating to operating costs was confidential, respondents generally felt unable to, or chose not to, comment on the details of this specific issue. GEL acknowledged OUR's proposed approach but noted that they needed to see the actual amounts proposed in the draft decision. They also commented on the treatment of tax and the increase in costs faced by the business as a result of the move from TRV to TRP.

The DG will adopt a pragmatic and high level approach to setting base year and future operating costs, taking GEL's reasonable forecasts of imported electricity fuel costs as the basis for future years. Other costs will be rolled forward from the base year using RPI and adjusting for efficiency savings as appropriate. He acknowledges GEL's comments in regard to taxation and the step change in TRP will be taken into account in the baseline figures for any ongoing efficiency savings. The DG notes the difficulty for other stakeholders to comment on this area and will in future seek to place more information in the public domain.

### **Pass Through mechanism**

*A major issue with the provision for passthrough costs over the current price control period was the speed at which these costs were recovered in tariffs. A number of issues were discussed and alternative approaches considered.*

**Respondents were asked to comment on alternative approaches and requested to propose approaches considered appropriate.**

#### **Response**

Respondents agreed that cost pass through should occur in a timely manner. Both GGL and GEL suggested that GEL be allowed to set its own increase in prices during the year that additional costs were incurred. GGL suggested that in accordance with arrangements in other markets that the company should be penalised if it over or under recovered costs as a result. Overall GEL welcomed OUR's proposal to reduce the time delay in recovering costs but would prefer to make adjustments within the year that additional costs were incurred.

**The DG recognises the concern to recover costs as soon as possible, but notes the need to balance the speed of recovery with the need for accurate information. He is not persuaded that GEL should be allowed to make its own price adjustments within year.**

**The proposed revised Cost Pass Through mechanism is set out in Annex C, and the cost pass through issues for the 2007-2011 price review period are set out in section 7 of this paper.**

**Broadly, the mechanism seeks to strike the balance between speeding up the pass through process and the accuracy of the information about increases in costs. It allows any price or currency hedging carried out by the company to be considered taken into account and it allows for shortfalls (or surpluses) in overall revenue to be recovered.**

**There is a question as to how increases in costs occurring in 2010/11 should be treated. Whether it should use the revised pass through mechanism proposed in this paper, the existing method or be wrapped up in the price setting process for 1 April 2012 onwards. Views are sought on this issue in the draft decision.**



## Summary

The main changes implemented as a result of the consultation are to:

- Move to a single year price control for 2011-12;
- Apply price limits on a revenue cap rather than on a tariff by tariff basis;
- Request GEL to publish all its tariffs, including its buy back tariff;
- Trial the capex incentive mechanism on a one year basis;
- Revise the cost pass through mechanism to simplify it and enable it to be applied sooner.

In addition, in light of concerns raised in response to the consultation, the OUR will carry out further work to review tariffs during 2011.

## 5. Scope and Principles of the Draft Decision

### Allowable Revenue

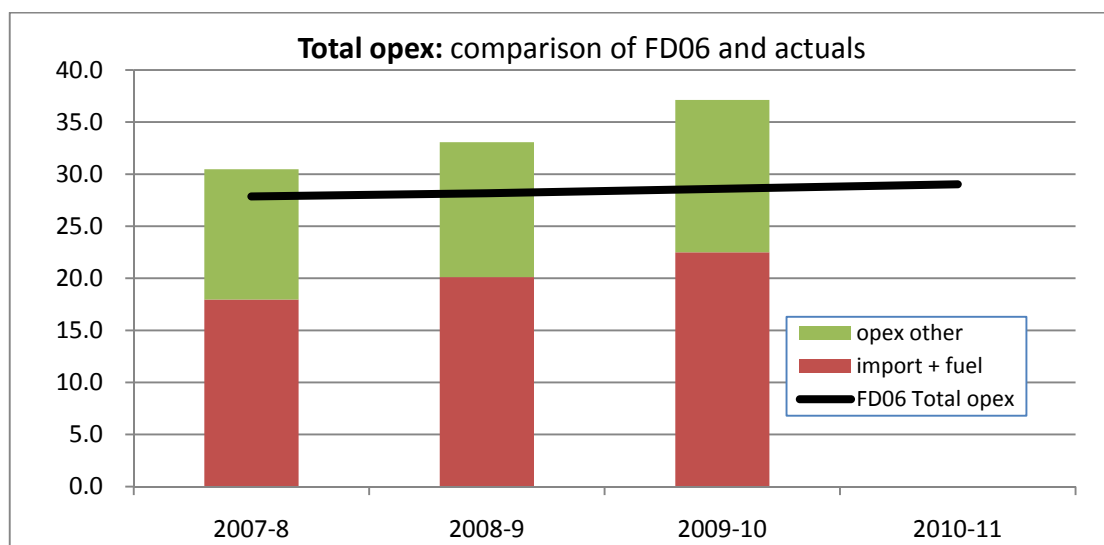
As in previous price controls, the amount of revenue GEL is allowed to recover from its customers, and hence the level of any increase (or decrease) in prices is determined by a number of factors.

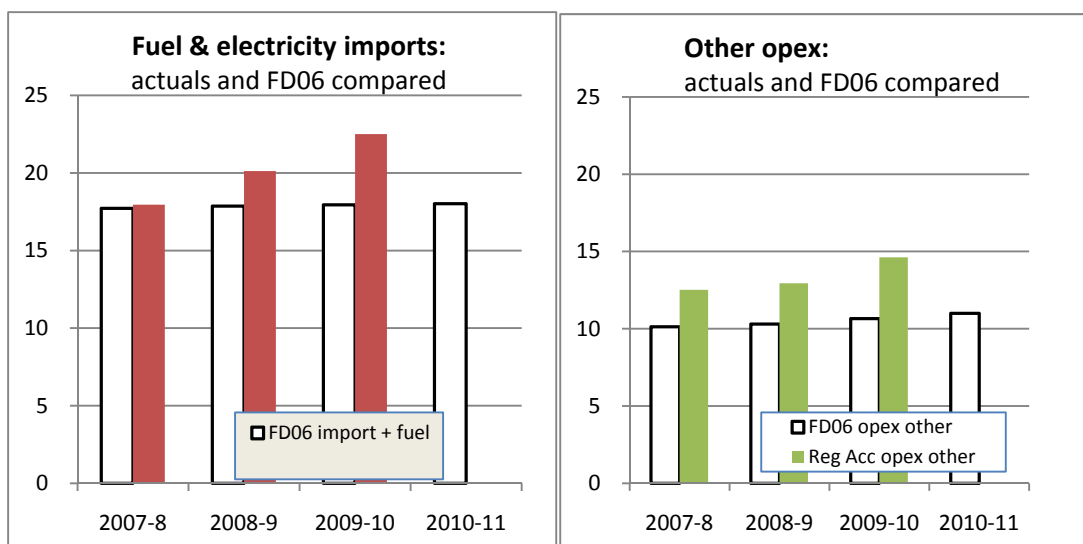
- Operating costs
- Proposed (and delivered) efficiency targets
- Regulatory rate of return (cost of capital) & Depreciation
- Regulatory capital value (the RAB or Regulatory Asset Base)
- Treatment of assets acquired prior to commercialization
- Level of profits, tax and dividends.
- Capital expenditure
- Level of save to spend fund required to finance the investment programme.

#### *Operating costs and efficiency*

The DG will base the allowance for future operating costs on the figures submitted by GEL, but will apply an ongoing efficiency target for the business to achieve year on year reductions in its operating costs. The DG notes that current levels of costs are significantly higher than assumed when prices for the current year were originally set in 2006. To a large extent this increase has been driven by increased electricity and oil import costs facing the business, but there has also been an increase in the general level of other operating costs.

The charts below set out to compare the operating costs assumed by the DG in setting prices for 2007-2011 (FD06) and the outturn costs achieved by the business.





To indicate the scope of savings that have been proposed by regulators a summary of operating expenditure efficiency assumptions adopted by UK regulators is set out below.

Figure: Summary of Efficiency Assumptions adopted by UK Regulators

Company	Duration	Real reduction
British Gas (1991)	1992-1997	2.5% pa
BG Transco (1996)	1997-2002	3.1% pa
British Gas Trading (1996)	1997-2000	4% pa
BT (1996)	1997-2001	3%-4% pa
NGC (1992)	1993-1997	5% pa
NGC (1996)	1997-2001	2.5% pa
REC Distribution (1995)	1995-2000	2% pa
REC Distribution (1999)	2000-2005	2.3% pa
REC Supply (1993)	1994-1998	2% pa
REC Supply (1997)	1998-2000	2% pa
Scottish Hydro (1994)	1995-2000	2% pa
Scottish Transmission (1993)	1994-2000	2% pa
NIE Distribution (1997)	1997-2002	1.7% pa
NIE Supply (1997)	1997-2001	1.5% pa
Water/Sewerage (1994)	1995-2000	2% pa
Water/Sewerage (1999)	2000-2005	2.7% pa

Source: Europe Economics<sup>6</sup>

<sup>6</sup> Europe Economics: A report for the office of the rail regulator, July 2000

These efficiency targets are also significantly less than the “average” sustained levels of efficiency improvements achieved by a range of utilities over a long period of time in the UK.

Figure: Compound Annual Real Reductions

<b>Water</b>	-3.7%
<b>Sewerage</b>	-4.1%
<b>Electricity transmission</b>	-6.5%
<b>Electricity distribution</b>	-6.8%
<b>Gas transportation</b>	-9.1%

Source: Europe Economics<sup>7</sup>

The above provides a useful context in terms of regulatory precedent and the actual efficiencies achievable by businesses operating in those industries that in many important respects share common features with GEL.

Such comparisons suggest substantial cost reductions in the range -3.7% to -9.1% in real terms have been achieved by these businesses since their privatisation and regulation. The efficiencies actually achieved have also exceeded those set by the regulators by some margins. The Europe Economics study highlights that falling unit costs were accompanied by improved service quality and these industries have achieved productivity growth significantly faster than the economy as a whole and generally faster than they managed before privatisation. This underlines the considerable success of commercialisation and privatisation in the UK, leading to substantial efficiencies and improved quality of service.

On Guernsey, GPL (Guernsey Post Limited) has a target to improve efficiency by reducing its overhead costs by £1m of a total overhead cost of £7.5m. This is a 13% reduction over the course of three years, with further substantial savings to be achieved in other operating costs over the same period.

The DG notes the States’ guidance to T&R, highlighted in Section 3 above which states that financial performance targets should be set to deliver improved efficiency. The DG has decided to set an efficiency target for GEL of 5.5% per annum of its non pass through costs and to complete the remaining efficiency programme set out by PPA and agreed at the last price review. This is effectively a reduction in its overall operating costs of approximately 2% per annum in real terms. The figure is in line with figures set by regulators in various other sectors, and with previous studies of the level of efficiency savings achieved by other regulated utilities in the period following commercialization.

In keeping with the move to a less “hands on” approach, the proposed efficiency target is a general target, rather than one which is based on identifying specific items of savings to be

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<sup>7</sup> *Europe Economics: A report for the office of the rail regulator, July 2000*

achieved. The DG has accepted GEL’s forecast of the level of external market costs as the basis for future operating costs.

The target translates to an effective reduction of £0.8m pa (in real terms) – in other words, it would offset around half of the typical inflationary increases seen in Guernsey in an average year. So, after allowing for inflation of 3-4% per annum, a 2% (real terms) year on year reduction in total operating costs, would still allow for a 1 or 2% per year increase in the level of GEL’s overall operating costs.

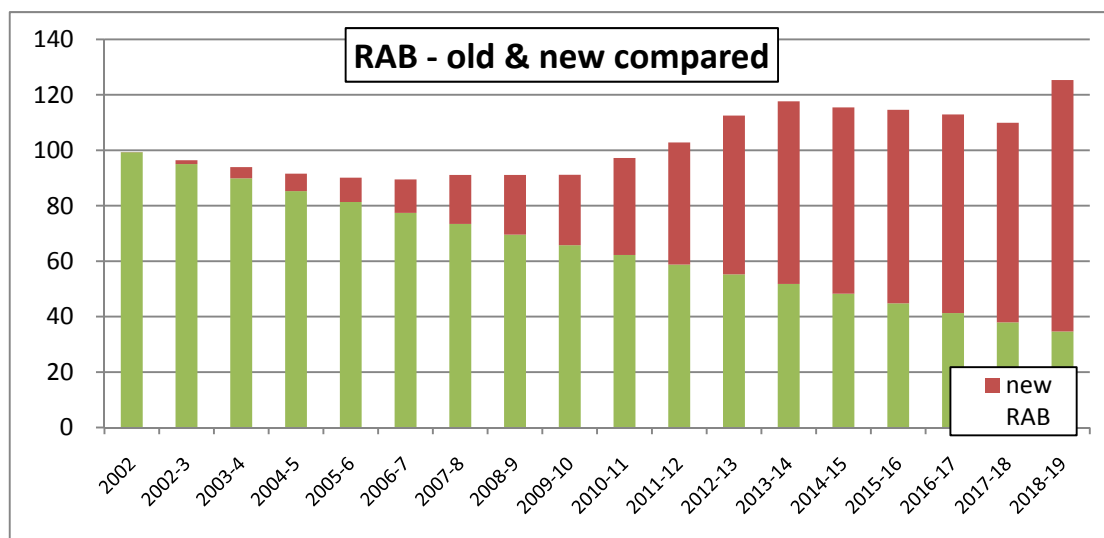
In setting this target, the DG has taken into account the impact of increased electricity imports and oil costs that are driven by external markets and made provision in future operating costs in line with GEL’s own forecasts. It should also be noted that the Cost Pass Through mechanism will continue to operate, and this safety net will permit GEL to seek an increase in prices if electricity imports or fuel costs rise significantly above the forecast level or if there is a shortfall in income, for example, from reduced electricity demand.

### ***Regulatory Asset Base, Depreciation and Cost of Capital***

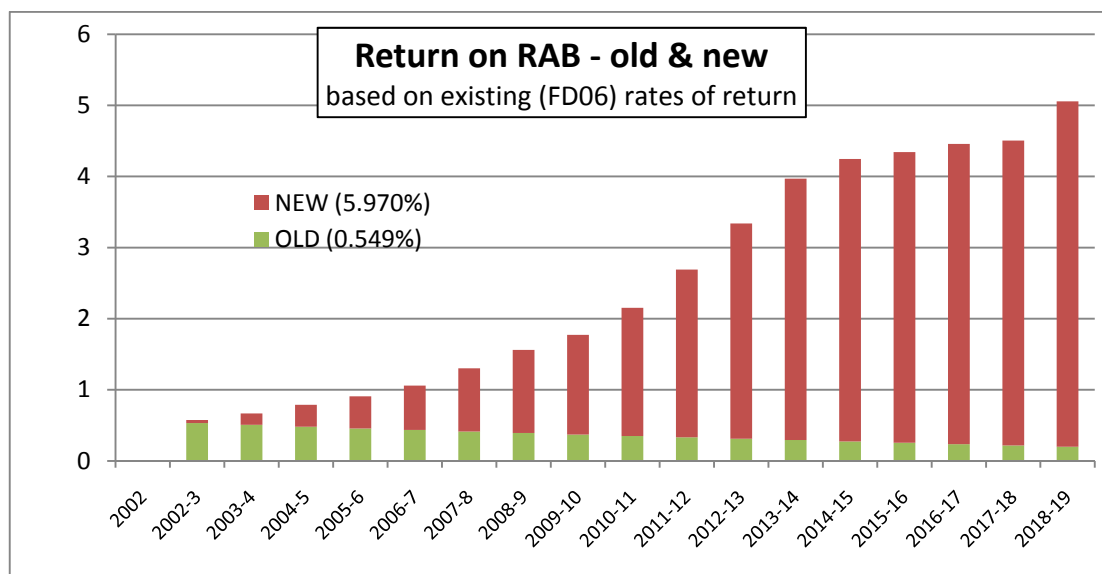
Following review by the expert panel in 2006 it was determined that the appropriate rate of return on the pre-commercialization assets was 0.549% and this continues to be the case. For new assets, the appropriate cost of capital was deemed to be 5.97% related to the cost of equity (since GEL does not finance investments through debt – as per the States policy of Save to Spend). The DG has determined that this continues to be an appropriate rate of return to allow GEL on its post commercialisation.

The DG accepts the asset depreciation schedule proposed by GEL subject to the effect of any changes arising from the discussion of core and non-core assets below.

The current total regulatory asset base is £91.2m (NBV). This is split between assets inherited at commercialisation £65.8m and new assets £25.4m.



The impact of this is that as older assets become fully depreciated and new assets replace them, the company's average rate of return on its assets will increase.



### **Core and non-core assets**

There are some issues relating to the company's RAB which the DG believes should be addressed prior to the final decision on prices for 2011-12. These include acquisition and the inclusion of non-core assets in the Regulatory Asset Base and the subsequent assignment to electricity customers of the costs (including the return on assets, depreciation and subsequent write downs). There appears to be a similar issue over the funds available to the business, where a significant negative position in the non-core business is offset by (and weakens) the strong financial position of the regulated business.

It is clearly unreasonable for Guernsey Electricity customers to pay through their electricity bills to finance non core activities and the DG expects the company to operate with such transactions on an "arms length" basis in accordance with its licence. It would be reasonable for the non-core business to bear the cost of the benefits it receives – whether in the form of funding or purchase and subsequent transfer of assets. These transactions should take place at a transparent and reasonable market based price. Furthermore, where the cost of maintaining a non-core asset has been borne by the core regulated business or was inherited from the states at commercialization, the DG expects any subsequent benefits from the sale, disposal or development of such assets to be shared with the core business.

### **Level of Profits, Tax and Dividends**

The level of profits "targeted" each year is determined by the return allowed on the regulatory assets and by the degree to which the company over or under achieves its efficiency targets and the level of delivery against any other incentive schemes in operation at the time.

For the purpose of this review, the OUR has assumed that tax rates applicable to the company remain as they are at present. No specific tax modelling has been undertaken nor

is it deemed necessary since investment is funded from the “save to spend” reserve and there are no issues over the tax treatment of debt.

OUR has also assumed that the dividend policy remains unchanged, that is, that one third of net profits will be distributed as a dividend to the shareholder.

### **Capital expenditure**

GEL set out the profile of its capital investment programme in the information submitted to OUR. The programme for the five years including the current year is summarized below.

<b>Capex, £m</b>	<b>2010-11</b>	<b>2011-12</b>	<b>2012-13</b>	<b>2013-14</b>	<b>2014-15</b>
<b>Generation</b>	6.7	8.2	10.6	8.0	0.4
<b>Conveyance</b>	2.3	1.4	3.0	1.4	1.9
<b>Supply</b>	2.3	1.6	1.8	2.0	2.4
<b>Total</b>	<b>11.3</b>	<b>11.2</b>	<b>15.4</b>	<b>11.4</b>	<b>4.7</b>

This is an ambitious programme and a significant increase over previous years – with the exception of the company’s investment in the CIEG cable link – when capital investment has typically been of the order of £2m to £4m per annum. Nevertheless, the company is confident that this programme is achievable. They have highlighted a risk that some expenditure may slip from late in the current year (2010-11) to early 2011-12 but this would have an impact on the timing rather than the overall level of investment.

The DG indicated in his earlier consultation his intention to allow the investment programme as proposed by GEL. There are no specific adjustments to this investment programme. However, the DG proposed that an incentive mechanism be set up to include investments in the company’s RAB only when completed and, in the case of increased generation capacity, when required, in line with increased peak demand from customers to meet the “N-2” security of supply obligation.

### **Incentive Mechanism for Capital Investment**

The DG has decided that in accepting GEL’s proposed investment programme as it stands, there is a need both to monitor progress against that programme and to put in place an incentive mechanism to share the risks between customers and the shareholder.

GEL should provide a more detailed summary of the investment programme setting out the investment profile of the main projects (those with a value of > £1m), key milestones and the forecasts of (maximum) demand and other relevant performance measures that are driving the investment. This will need to be updated annually and reviewed by OUR against the incentive mechanism set out below. The DG plans to publish the details in the Final Decision document in March.

The most significant part of the investment programme is the installation of new generation capacity to meet forecast increases in peak demand. The DG proposes to reduce GEL's allowed revenue by an amount equal to the return on investment for each unit (MW) that peak demand falls below the level forecast by GEL.

Revenue adjustment = (MW shortfall/capacity increase) x (cost of increase) X RoR

So, for example if the investment required for an additional 12MW capacity is £10, and maximum peak demand is 2MW less than GEL's forecast, the adjustment would be:

Example adjustment:  $2\text{MW}/12\text{MW} \times £10\text{m} \times 5.97\% = £0.1\text{m}$

The DG recognises that this mechanism is more appropriate in the medium or longer term price setting process, when the ups and downs in peak demands and in forecasting will tend to average out over a number of years. Nevertheless, the DG proposes to include the mechanism in this one year price control to give an opportunity for the process to be trialled.

### ***Save to Spend***

The DG has reviewed the company's core investment programme against the OUR's assessment of the current position of the state of the save to spend reserve (as set out in the consultation document OUR 10/13) and against the more pessimistic view of the save to spend reserve held by GEL. He is satisfied that in neither case would any additional provision in price limits be required to finance the current approved investment programme. In other words, the cash generated by the business in the normal course of its operations (at the expected level of profitability) will be sufficient to finance investment.

However, the DG notes that on the basis of the more pessimistic cashflow scenarios there are some periods in the future when the balance of the save to spend reserve becomes relatively low. It is therefore possible that if circumstances change, he would need to allow GEL to increase prices to help finance future investments.



## 6. Cost Pass Through

In its response to the price consultation, GEL notes that the Cost Pass Through mechanism (CPT) is the main issue which has required examination over the past four years.

CPT allows the company to recover increases in costs that are beyond its control – such as increases in the price of oil or imported electricity – without a full price review. The prices of both are driven by external market pressures and subject to additional currency risks.

There are means by which GEL can ameliorate these risk in the short term (by hedging its exposure but they can only be short term measures and the underlying increases in costs will ultimately be passed on to electricity customers. It is these external currency and market price pressures that led to the substantial price increases in 2009 and 2010 (17% and 8.5%).

Among the issues raised by GEL is the delay between the incurring of costs and their recovery through price increases in April of the following year. It is also seeking clarity over the pass through of cost increases incurred in the 2007-11 price control period and the phasing in of the under recovered costs over a number of years.

To that end, GEL submitted a separate confidential annex to its response to the price control consultation. Given the materiality of the impact of this cost pass through (GEL are seeking an extra £18m over and above the amount required in the normal price control process) and given the impact that it could potentially have on customer's bills there is a strong case that this information should be publicly available.

The following table sets out GEL's view of the costs and the amounts recovered to date.

	GEL initial estimate	GEL latest view of cost	Recovered to date <sup>8</sup>	Shortfall
<b>2007-08</b>	£5.5m	£5.5m	£5.0m	£0.5m
<b>2008-09</b>	£4.9m	£3.5m	£3.5m	£1.4m
<b>2009-10</b>	£7.2m	£13.5m	£7.2m	£6.3m
<b>2010-11<sup>9</sup></b>	£10.7m	£10.7m	-	£10.7m
<b>Total</b>	£28.3m	£34.6m	£15.7m	£18.9m
<b>Total (ex 2010-11)</b>	£23.9m	£5.0m	£15.7m	£8.2m

The figure of £7.2m allowed to date for the 2009-10 cost pass through was based on the estimate of increased costs at the time of GEL's submission in October 2009.

GEL have indicated that they would be content to include only part of the CPT from previous years in their price limit for 2011-12, but with the understanding that the remaining

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<sup>8</sup> Amount allowed to date by OUR in the 17% and 8.5% price increases.

<sup>9</sup> Estimated

amounts outstanding would be available for them to draw on in future years. They suggest that this could be achieved by using a control account for cost pass through amounts.

The DG notes GEL's view. He welcomes the company's willingness to recognise the pressure on customer's bills by including only part of the pass through costs in the first year of the new price control. This is particularly welcome in light of the steep increase in bills already faced by customers in 2009 and 2010.

However, the DG notes that general regulatory practice is to treat each new price control as a complete review of the financial position of the business. Cost pass through is intended as an interim measure, short of a full price review, to allow a regulated business to recover additional revenue against cost increase in some specific areas outside of its control. The DG also notes the issues raised and particular concern over the time taken for cost pass through to come into effect and agrees that a shorter timescale would be appropriate.

Therefore, in the light of this, the fact that he is setting a price control for only a single year and that he intends to make some changes to the operation of the pass through mechanism, he proposes not to include cost pass through for 2010-11 in this decision. This will instead be reflected in potential tariff cap changes in October 2011 (under the revised CPT mechanism) or in the revised prices from 1 April 2012. However he has decided to include the remaining CPT pass for 2009-10 in the current price review.

OUR has carried out the following assessment of GEL's claim for additional cost pass through for 2009/10 and has reviewed the costs in GEL's submission against the information presented in their regulatory accounts, the annual report and information returns for this price review.

The cost pass through claim is divided into 3 parts:

- increased oil and electricity import costs compared to the 2006 price review;
- pass through of 50% of any "excess" import costs above a market assessment;
- adjustment for a shortfall in revenue – allowing 85% of any shortfall;

For 2009-10 the relevant figures are:

	OUR 2006 price review	GEL figure for CPT claim	Regulatory & Statutory Accounts
Fuel (oil)	£7.0m	£9.7m	£6.6m
Electricity import	£7.6m	£16.9m	£15.9m
Total	£14.6m	£26.6m	£22.5m
Unit (kWh) revenue	£34.3m	£32.4m* <sup>1</sup>	-
Total Revenue	£42.8m <sup>1</sup>		£41.6m

\*<sup>1</sup>deflated/inflated for 17% 2009-10 price increase

The comparison of the figure claimed by GEL and OUR's assessment of the appropriate level of cost pass through is as follows:

	<b>GEL claim</b>	<b>OUR assessment</b>
Fuel+import costs	£11.8m	£7.9m
Allowance for excess <sup>2</sup> costs	£0.06m	-
Revenue shortfall	£1.6m	£1.0m
<b>Total</b>	<b>£13.5m</b>	<b>£8.9m</b>
Additional CPT - over pass through to date	<b>£6.3m</b>	<b>£1.6m</b>

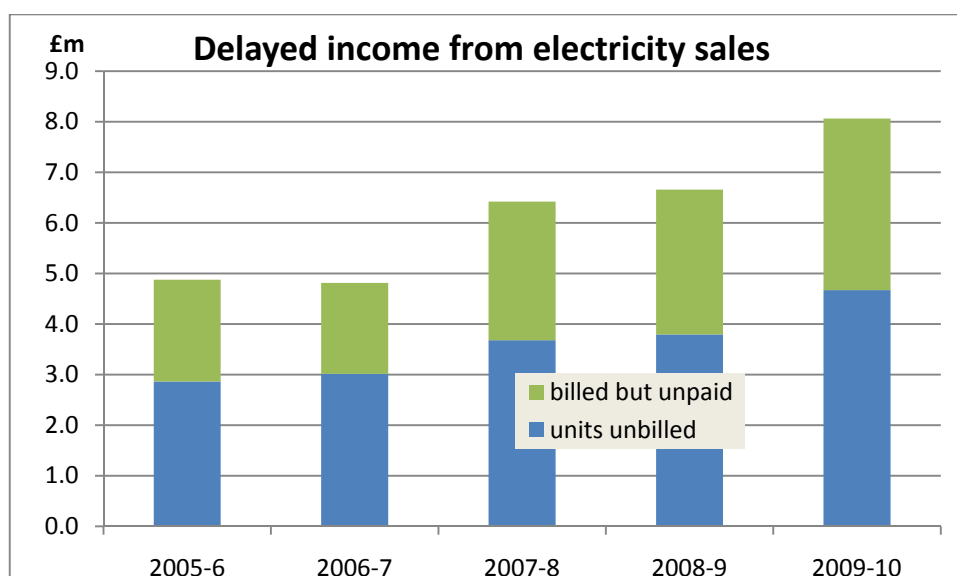
<sup>2</sup>costs in excess of market price based calculation

This gives a difference of nearly £5m between GEL's claim and OUR's assessment of the required amount. The discrepancy appears to be driven by:

- the difference in CPT claim for fuel costs and the costs reported in the accounts;
- different views of the "unit related" revenue and use of different pricing years;

For this price review, the DG proposes to include the full OUR assessment of the additional 2009-10 CPT amount of £1.6m in the price limit set for April 2011. He does not intend to revisit the cost pass through amounts for prior years (2007-8 and 2008-9).

The DG also notes that in the case of the shortfall of revenue, there is an additional and offsetting issue to be taken into account. This is the deferral of revenue from one year to the next because of the time between when the units are used by the consumer, the issuing of the bill and subsequent payment by the charges for the units used. This is part of the normal course of business for a utility and in normal circumstances, where from one year to the next, the amount of energy sold and prices are similar, there should not be an issue. However, when there is a significant change in prices (up or down), there can be a substantial shift of income from one year to the next – so an apparent shortfall in income can be caused by the normal delay between use, billing and payment. This is illustrated in the following chart:



This shows that the revenue reported in 2009-10 would appear to be approximately £1-£2m lower than the value of the units consumed during the year. Rather than a true shortfall, it would appear that there is a delay in the timing of the receipt of those revenues.

As already noted, the DG welcomes GEL's offer to accept a reduced amount of pass through. However, this offer was made assuming a slightly higher overall price increase than that proposed in OUR's draft decision (see below) and GEL assumed a further £6m of CPT for 2009-10 and prior years would be carried forward for future recovery. Therefore he has included the full amount of £1.6m in the proposed prices for 2011-12.

The DG is also aware that leaves open the issue of CPT for the additional costs incurred in 2010-11. It is the DG's view that because of the uncertainty that has arisen in the 2009-10 CPT calculation; this is best dealt with when the actual costs for 2010-11 are known. It is proposed that this is done using the revised CPT mechanism proposed above – which would enable it to take effect in October 2011, or in the more comprehensive process of setting future prices at the next price review in 12 months time.

However, the DG recognises that this is a change to the pass through arrangement for 2010-11 agreed in the 2006 price control and could result in a slightly different figure to one that would be calculated under the present arrangement. He would welcome GEL's view on whether it would be preferable to use the revised or unrevised CPT calculation for 2010-11.

## 7. Draft Decision

This document sets out the overall, capex and operating expenditure for GEL over the next 4 years. However, in light of :

- Substantial capex programme, recent changes and some ongoing uncertainty over the timing/delivery of investment;
- Review of the scope for future efficiency savings, especially in regard of opex;
- Preferences expressed in consultation by some respondents for shorter rather than longer term price control period;

The DG is inclined to formally set the price control only for the single year, 2011-12. Figures for later years should therefore serve as a guide to what is likely to happen to future prices but will not form part of this price control.

The overall price limits will be those set out in the table below. Please note that the revenue requirement is stated in real terms (ie, without inflation for future years).

	Current year	Price control	Indicative figures for future years (excluding cost pass through)		
	2010-11	2011-12	2012-13	2013-14	2014-15
<b>Required revenue(real)</b>	<b>47.1</b>	<b>48.0</b>	<b>48.4</b>	<b>50.1</b>	<b>50.2</b>
<b>Price adjustment (X)</b>		+2.8	-6.3	-0.3	-3.5
<b>RPI assumption</b>		3.5%	3.5%	3.5%	3.5%
<b>RPI+X Price increase</b>		<b>+6.3%</b>	<b>-2.8%</b>	<b>+3.2%</b>	<b>0%</b>
Notional unit price ("avg" after increase)	12.5	13.3	12.9	13.3	13.3

More information is provided on the detail of this draft decision in Annex B.

## 8. Next Steps

The DG invites responses to this draft decision and has allowed a four week period for responses in line with his consultation guidelines, after which he will issue his final decision for implementation on 1<sup>st</sup> April 2011.

## ANNEX A - Tariffs

[list of tariffs in price control]

### Standard Tariff:

- Primary Standing charge;
- Secondary Standing Charge; and
- Unit charge;

### Industrial Economy Tariff

#### – High Voltage Supplies:

- kW charge (April-Oct);
- kW charge (Nov-March);
- Low rate unit charge;
- Normal rate unit charge;
- Standby Charge; and
- Power Factor adjustment

### Maximum Demand Tariff

#### – High Voltage Supplies:

- kW charge (April–October);
- kW charge (Nov-March);
- Unit charge
- Standby Charge; and
- Power Factor adjustment

### Heat Pump Tariff:

- Unit charge;

### Non-Peak Tariff:

- Standing charge; and
- Unit charge;

### Public lighting Tariff:

- Standing charge; and
- Unit charge;

### Super Economy 12:

- Primary Standing charge;
- Secondary Standing charge;
- Low rate unit charge; and
- Normal rate unit charge

### Industrial Economy Tariff

#### – Low Voltage Supplies:

- kW charge (April-Oct);
- kW charge (Nov-March);
- Low rate unit charge;
- Normal rate unit charge;
- Standby Charge; and
- Power Factor adjustment

### Maximum Demand Tariff

#### – Low Voltage Supplies:

- kW charge (April-October);
- kW charge (Nov-March);
- Unit charge;
- Standby Charge; and
- Power Factor adjustment

### Superheat Tariff:

- Standing charge; and
- Unit charge;

### Boiler Tariff:

- Standing charge; and
- Unit charge;

## ANNEX B – Financial Tables

All costs in £m

	2010-11	2011-12	2012-13	2013-14	2014-15
Opex (Fuel + imports)	25.3	26.7	27.5	29.5	30.3
Opex (Other)	14.3	14.8	15.3	15.9	16.4
Efficiency	0	.8	1.7	2.7	3.7
<b>Opex (total)</b>	<b>39.6</b>	<b>40.6</b>	<b>41.0</b>	<b>42.6</b>	<b>42.8</b>
<b>Depreciation</b>	<b>5.3</b>	<b>5.6</b>	<b>5.7</b>	<b>6.3</b>	<b>6.9</b>
<b>Return on RAB</b>	<b>2.1</b>	<b>2.7</b>	<b>3.3</b>	<b>4</b>	<b>4.2</b>
<b>Capex</b>	<b>11.4</b>	<b>11.2</b>	<b>15.4</b>	<b>11.4</b>	<b>4.7</b>
<b>Cost Pass Through</b>		<b>1.6</b>			
<b>Price change (X)</b>		<b>+2.8</b>	<b>-6.3</b>	<b>-0.3</b>	<b>-3.5</b>
<b>RPI + X (RPI@3.50%)</b>		<b>+6.3</b>	<b>-2.8</b>	<b>+3.2</b>	<b>0</b>

Note

Efficiency target of 5.5% reduction has been applied on non pass through costs, equivalent to 2% across all opex.



## ANNEX C – COST PASS THROUGH

The OUR will implement a revised approach to Cost Pass Through (CPT) which will:

- Enable faster pass through of costs
- Maintain a relatively simple and straightforward approach
- Allow verification of the relevant figures

The purpose of CPT is to allow the regulated business to cope with unforeseeable increases in its external costs in the period between price reviews. For GEL, the key cost areas are the import of oil for on island generation and electricity via the CIEG (Channel Island Electricity Grid), both of which are driven by external global or European markets.

The mechanism also allows for the recovery of part of a shortfall in revenue where this is caused by a reduction in electricity demand. This serves two purposes. It enables the business to continue to generate the revenue it needs for its investment programme. It also ensures that GEL is not penalised financially for improving the overall efficiency with which energy is used on the island, which is to the benefit of Guernsey and GEL's customer base as a whole<sup>10</sup>. For this reason it is proposed that the revised CPT allows full pass through of revenue shortfall and simplifies the process by considering all electricity revenues.

CPT is not intended to allow GEL to recover general increases in its costs or to make up for failing to achieve efficiency improvements in its business – the cost of these will be borne by the company and its shareholder.

The OUR considered two main ways in which the operation of the cost pass through mechanism can be improved in order to speed up the process:

- Use calendar year information to allow decisions to be made in time for GEL's usual annual tariff change in April;
- Continue on a financial year basis but allow GEL to make tariff adjustments for CPT in October following the end of the financial year. This is GEL's preferred option.

Both approaches have their merits, but after consideration, the DG is minded to adopt the latter proposal. GEL will be allowed to make a tariff adjustment in October as determined by the DG in circumstances where additional costs arise and there is a justification for GEL to pass them on to customers. It would also allow the use of figures that had been audited. It is also the approach preferred by GEL.

The present approach to CPT includes, for electricity imports, an assessment of costs against a market benchmark, and to allow a proportion (currently 50%) of costs above this

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<sup>10</sup> *in the longer term, the benefits of improved energy efficiency will be passed on to all customers through lower energy costs and the deferral of investment in increased generation/import capacity.*

benchmark. While this is desirable, a similar approach is not applied to oil imports and nor is a simple and easily applied benchmark available. To simplify the process, all costs are to include the benefit of any offsetting gains from hedging activity for the current or previous years<sup>11</sup>.

### ***Cost Pass Through Calculations*** <sup>12,13</sup>

The revised calculations would be as follows:

#### Electricity:

$$\text{CPT(elec)} = \{\text{actual vol of imports} \times \text{actual costs}\} - \{\text{FD allowed vol of imports} \times \text{allowed price}\}$$

#### Fuel:

$$\text{CPT(fuel)} = \{\text{actual vol of imports} \times \text{actual costs}\} - \{\text{FD allowed vol of imports} \times \text{allowed price}\}$$

#### Revenue:

$$\text{CPT(rev)} = \{\text{FD assumed Electricity Revenue}\} - \{\text{actual electricity revenue}\}$$

#### Overall Cost Pass Through:

$$\text{CPT(total)} = \text{CPT(elec)} + \text{CPT(fuel)} + \text{CPT(rev)}$$

### ***Symmetry***

The revised Cost Pass Through arrangement will operate symmetrically. To the extent that any of these figures are negative – ie, costs are lower than anticipated in the final price decision, they will be used to offset the overall cost pass through. That is, increases in one area can be offset by decreases in another for an overall figure.

The CPT mechanism will also apply to reduce charges where the overall costs are less than envisaged in the original price decision and they exceed the materiality threshold. Where CPT can be applied to reduce charges it will be for the DG's discretion to determine whether to apply a reduction immediately or to wait until a full price review to pass on the benefits. GEL will have discretion to decide whether to apply the full value of any increase in prices.

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<sup>11</sup> Where gains have not yet been realised, GEL must disclose the nature of any hedging activity carried out and the current estimate [based on current market prices] of the likely outcome.

<sup>12</sup> Allowed price, volume & assumed demand refer to the figures used in the FD of the latest price control adjusted for inflation and/or subsequent price increases as appropriate.

<sup>13</sup> Actuals refer to actual units imported and actual volumes of fuel used [not to volumes purchased which may be carried over to other years]

### **Materiality**

There will be a materiality threshold of £1m, roughly equivalent to a 2% price increase, and the Cost Pass Through provisions will come into effect only when the aggregate value of the three elements exceeds £1m.

### **Timing**

It is intended that changes to tariffs be applied from 1 October of the year in which a CPT application is made. In order to achieve this, the company will need to make an application by 31 July of the year in question and ensure its annual report & accounts and its regulatory accounts are available to the OUR at that time. The DG undertakes that he will examine the evidence and make a decision on the amount of any CPT by 31 August. This will enable a price increase to be given the necessary 4 weeks notice to be applied from 1 October.

Cost pass through applications will be for one year at a time, and previous years will not be considered except where either:

- (i) GEL requested an adjustment the previous year but it did not meet the materiality threshold; or
- (ii) The DG did not apply a downward adjustment the previous year and uses it to offset the impact of CPT for the year in question.

### **Worked example**

Please note that although this example uses figures from 2009-10, the new arrangement will apply for cost pass through applications made from 1 April 2011 onwards – ie, the financial year 2010-11 would be the first to be considered under this revised approach.

<b>2009-10</b>	<b>FD2006</b>	<b>Actuals</b>	<b>Pass through amount</b>
Oil costs	£7.0m	£6.6m	<b>-£0.4m</b>
Electricity import	£7.6m	£15.8m	<b>£9.2m</b>
Total Revenue	£42.8m <sup>14</sup>	£41.6m	<b>£1.1m</b>
Total pass through	-	-	<b>£8.9m</b>

This figure is in line with that assessed by OUR under the current CPT mechanism.

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<sup>14</sup> £36.6m uplifted by subsequent price increases